

**AGENDA ITEM 8**

**Executive Summary**

**PRESENT LAW AND BACKGROUND  
RELATING TO EMPLOYER-SPONSORED DEFINED  
BENEFIT PENSION PLANS AND THE PENSION BENEFIT  
GUARANTY CORPORATION (“PBGC”)**

Scheduled for a Public Hearing  
Before the  
SENATE COMMITTEE ON FINANCE  
on March 1, 2005

Prepared by the Staff  
of the  
JOINT COMMITTEE ON TAXATION

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## EXECUTIVE SUMMARY

### Overview of present law relating to defined benefit pension plans

#### In general

A plan of deferred compensation that meets the qualification standards of the Internal Revenue Code (“a qualified retirement plan”) is accorded special tax treatment under present law. Employers are allowed a current deduction for plan contributions, but employees do not include plan benefits in gross income until the benefits are distributed. Assets in such plans accumulate on a tax-free basis, and benefits are not includible in gross income until distributed to plan participants. Most qualified retirement plan contributions are not subject to employment taxes. These special tax benefits are provided to make qualified retirement plans attractive to both employers and employees and thereby enhancing retirement income security.

Qualified retirement plans are subject to regulation both under the Internal Revenue Code and the Employee Retirement Income Security Act (“ERISA”). Among other things, the rules relating to qualified plans define the rights of plan participants, impose limits on the amount of benefits that can be received, and impose nondiscrimination requirements that are designed to help ensure that a plan benefits a broad cross section of employees and not just highly compensated employees.

Qualified retirement plans are classified generally into two types: defined contribution plans and defined benefit pension plans. Under a defined contribution plan, each plan participant has his or her own individual account and the benefits are required to be based solely on the account balance, including investment gains and losses. Thus, participants bear the risk of investment loss under a defined contribution plan. In contrast, defined benefit pension plans provide benefits in accordance with a formula set forth in the plan.<sup>2</sup> In order to help ensure that assets in defined benefit pension plans are sufficient to pay promised benefits, present law imposes minimum funding rules which require employers to make a minimum level of contributions to the plan. Within limits, benefits under a defined benefit pension plan are insured by the Pension Benefit Guaranty Corporation (“PBGC”).

Defined benefit pension plans are sometimes classified as either single-employer plans or multiemployer plans. A single-employer plan is a plan maintained by one employer. A multiemployer plan is maintained pursuant to one or more collective bargaining agreements and to which more than one employer contributes (and which meets other requirements as specified by the Secretary of Labor).

<sup>2</sup> In recent years, certain types of “hybrid” plans have developed, which have features of both a defined benefit pension plan and a defined contribution plan. For example, a cash balance plan is a hybrid plan. Legally, a cash balance plan is a defined benefit pension plan; however, participants’ plan benefits are defined by reference to hypothetical

account balances that resemble accounts maintained for participants under a defined contribution plan.

#### Funding and deduction rules applicable to defined benefit pension plans

In general, a large portion of the benefits provided under defined benefit pension plans are payable in the future, and employers make contributions to fund the benefits over many years. In order to ensure that plan assets are sufficient to pay plan benefits when due, the minimum funding rules require employers to make annual plan contributions. The amount of contributions required for a plan year is generally the amount that is actuarially determined to be needed to fund benefits earned during that year plus that year's portion of other liabilities that are amortized over a period of years, such as benefits resulting from a grant of past service credit. The amount of required annual contributions is determined under one of a number of acceptable actuarial cost methods.

An additional contribution may be required under special funding rules (referred to as the "deficit reduction contribution" rules). These rules apply to single-employer defined benefit pension plans covering over 100 participants if the funded status of the plan is below certain levels. These additional funding requirements were enacted in 1987 and amended in 1994 to address demands on the PBGC insurance system as a result of terminations of under-funded plans.

In general, the additional contribution required under the deficit reduction contribution rules is determined by reference to the amount that would be needed to fund benefits under the plan if the plan terminated, that is, the excess of the present value of the benefit liability under the plan (referred to as "current liability") over the value of the plan's assets. Generally, any reasonable actuarial assumptions may be used in calculating required contributions under the minimum funding rules. However, in determining current liability, specific statutory interest and mortality assumptions must be used.

For plan years beginning before 2004 and after 2005, the interest rate used to determine a plan's current liability must be within a permissible range of the weighted average of the interest rates on 30-year Treasury securities for the four-year period ending on the last day before the plan year begins. The permissible range is generally from 90 percent to 105 percent (90 percent to 120 percent for plan years beginning in 2002 and 2003, and 90 percent to 100 percent for plan years beginning in 2004 and 2005). The Pension Funding Equity Act of 2004 ("PFEA 2004") changed the interest rate used in determining a plan's current liability for plan years beginning after December 31, 2003, and before January 1, 2006, to a rate based on rates of interest on amounts invested conservatively in long-term investment-grade corporate bonds.

Within limits, the IRS is permitted to waive all or a portion of the contributions required under the minimum funding standard for a plan year. A waiver may be granted if the employer responsible for the contribution could not make the required contribution without temporary substantial business hardship and if requiring the contribution would be adverse to the interests of plan participants in the aggregate. An employer is generally subject to an excise tax if it fails to make minimum required contributions and fails to obtain a waiver from the Internal Revenue Service (“IRS”).

Employer contributions to qualified retirement plans are deductible subject to certain limits.

Employers are required to provide plan participants and beneficiaries with certain information relating to the funded status of the plan.

### **The PBGC pension insurance system**

The PBGC was created in 1974 to guarantee benefits under most defined benefit plans in the event the plan is terminated with assets insufficient to pay promised benefits. The PBGC guarantees benefits under both single-employer plans and multiemployer plans. The maximum annual guaranteed benefit for single-employer plans terminating in 2005 is approximately \$45,600 per year. As of September 2004, the PBGC insured about 44.4 million participants in more than 31,200 defined benefit plans (including both multiemployer and single-employer plans).

An employer may voluntarily terminate a single-employer plan in a standard or a distress termination. In a standard termination, assets are sufficient to pay plan benefits. If assets are insufficient to pay plan benefits, the employer may terminate the plan only if the employer meets one of four criteria relating to financial distress of the employer (a “distress termination”). These criteria are designed to ensure that only employers in financial distress can terminate an under-funded plan and that other employers do not terminate plans and thereby transfer benefit liabilities to the PBGC. An under-funded plan may also be terminated by the PBGC.

The PBGC is funded by premiums paid by sponsors of covered plans, assets recovered from terminating plans, amounts recovered from employers that terminate plans, and investment earnings. The single-employer plan premium for all covered plans is \$19 per participant. In addition, plans with unfunded vested benefits are required to pay an additional premium equal to \$9 per \$1,000 of unfunded vested benefits. The additional premium reflects the concept that under-funded plans pose a greater risk to the PBGC insurance system.

Different rules apply to multiemployer plans under the PBGC insurance system. For example, a different premium structure applies, and the guarantee structure is different

As of September 30, 2004, the PBGC reported a total deficit of \$23.5 billion, more than double the 2003 fiscal year end deficit of \$11.5 billion. The PBGC has noted that its financial state is a cause for concern. The Government Accountability Office (“GAO”) has placed the PBGC on its high risk list.

### **Summary of President’s budget proposal**

The President’s fiscal year 2006 budget contains a series of proposals designed to address under- funding in defined benefit pension plans and the financial condition of the PBGC. The budget proposal repeals the present-law funding rules (including the deficit reduction contribution rules) and replaces them with a set of rules based on funding targets. In general, the budget proposal would:

- Measure a plan’s funding shortfall by reference to the excess of the plan’s funding target (generally the present value of previously earned benefits) over the market value of the plan’s assets, and require any shortfall to be amortized over seven years;
- Require benefits earned during a year to be currently funded, by requiring an additional contribution based on the present value of the benefits;
- Determine present value using interest rates drawn from a corporate bond yield curve and other assumptions that reflect the financial status of the employer;
- Increase the amount of deductible contributions that employers may make;
- Place restrictions on benefit increases, accelerated distributions (such as lump sums), additional benefit accruals, and the funding of executive compensation in the case of under-funded plans;
- Provide more timely reporting as to a plan’s funding status to the Treasury Department, the Department of Labor, the PBGC, and plan participants;
- Increase PBGC flat-rate premiums to \$30 per participant (with annual indexing) and replace PBGC variable-rate premiums with risk-based premiums;
- Freeze the level of benefits guaranteed by the PBGC if an employer enters bankruptcy proceedings and allow the PBGC to establish and perfect a lien against such an employer for required contributions that were not made; and

- Prohibit plans from providing unpredictable contingent event benefits (such as plant shutdown benefits).

### **Data relating to qualified retirement plans**

The recent U.S. Department of Labor's National Compensation Survey found that 57 percent of private sector employees had access to a qualified retirement plan and that 49 percent participated in such a plan in 2003. Among full-time employees, 67 percent had access to a plan and participation was 55 percent. Participation rates are higher among public sector employees. In the private sector, more employees have access to and participate in defined contribution plans (51-percent access rate, 40-percent participation rate) than in defined benefit pension plans (20-percent access rate, 20-percent participation rate). Some employees have access to and participate in both types of plans. There has been growth in defined contribution plan coverage, and a decline in defined benefit pension plan coverage.

### **Policy issues relating to defined benefit pension plans**

Almost all changes to the Federal pension laws require a balancing of competing policy objectives, including concerns regarding retirement income security, simplification, reduction of administrative burdens, and fiscal and tax policy. The relative decline in defined benefit pension plan coverage compared to defined contribution plan coverage has caused some to be concerned about a possible decline in retirement income security. Defined benefit pension plans are often thought to be more secure because of the minimum funding requirements and the PBGC guarantee. The reasons for decline in defined benefit plan coverage are not entirely clear, and may be the result of changing demographics, applicable legal restrictions, the desire of employers to control costs, as well as other factors.

Concerns have also been raised that the minimum funding requirements have not proved sufficient to ensure that benefits promised under defined benefit pension plans are adequately funded. To the extent that promised benefits are not funded, other PBGC premium payers may bear some of the burden. In addition, some promised benefits may be lost, which could reduce retirement income security.

The budget proposal seeks to increase the funded status of plans, reduce the risk of future under-funding, and increase the solvency of the PBGC insurance system.

Evaluating proposals relating to funding of defined benefit pension plans involves a variety of issues, including: what is an appropriate level of funding for an on-going plan; the potential burdens placed on employers and the extent to which excessive burdens may

cause a further shift toward defined contribution plans; providing adequate protection to employees; and concerns of possible over-funding of plans and the potential for the use of defined benefit pension plans as a source of tax-free funding for other purposes.

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